FED

RIN 3064-ZA32

Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Notice of proposed policy statement; request for comment.

SUMMARY: The Federal Deposit Insurance Corporation (FDIC) is requesting comment on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks. Although all financial institutions, regardless of size, may have material exposures to climate-related financial risks, these draft principles are targeted at the largest financial institutions, those with over $100 billion in total consolidated assets. The draft principles are intended to support efforts by large financial institutions to focus on key aspects of climate-related financial risk management.

DATES: Comments must be received no later than [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Commenters are encouraged to use the title "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (RIN 3064-ZA32) and to identify the number of the specific question(s) for comment to which they are responding. Please send comments by one method only directed to:

- *Agency Website***:** *https://www.fdic.gov/resources/regulations/federal-register-publications/index.html*. Follow the instructions for submitting comments on the agency's website.
- *Email*: *comments@fdic.gov*. Include RIN 3064-ZA32 in the subject line of the message.
- *Mail*: James P. Sheesley, Assistant Executive Secretary, Attention: Comments-

RIN 3064-ZA32, Federal Deposit Insurance Corporation, 550 17th Street NW, Washington, DC 20429.

- *Hand Delivery/Courier***:** Comments may be hand-delivered to the guard station at the rear of the 550 17th Street NW building (located on F Street NW) on business days between 7:00 a.m. and 5:00 p.m.
- *Public Inspection*: All comments received will be posted without change to *https://www.fdic.gov/resources/regulations/federal-register-publications/index.html* —including any personal information provided—for public inspection. Paper copies of public comments may be ordered from the FDIC Public Information Center, 3501 North Fairfax Drive, Room E-1002, Arlington, VA 22226 or by telephone at 877-275-3342 or 703-562-2200.

FOR FURTHER INFORMATION CONTACT: Andrew D. Carayiannis, Senior Policy Analyst, Capital Markets Strategies Section, *acarayiannis@fdic.gov*; Lauren K. Brown, Senior Policy Analyst, Exam Support Section, *laubrown@fdic.gov*; *regulatorycapital@fdic.gov*; Capital Markets and Accounting Policy, Division of Risk Management Supervision, 202-898-6888; Jennifer M. Jones, Counsel, *jennjones@fdic.gov*; Karlyn Hunter, Counsel, *kahunter@fdic.gov*; Amanda Ledig, Senior Attorney, *aledig@fdic.gov*; Supervision and Legislation, and Enforcement Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW, Washington, DC 20429. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), 800-925-4618.

SUPPLEMENTARY INFORMATION:

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I. Introduction

The effects of climate change and the transition to a low carbon economy present emerging economic and financial risks that threaten the safety and soundness of financial institutions and the stability of the financial system. [1, 2] Financial institutions are likely to be affected by both the physical risks and transition risks associated with climate change (referred to in these draft principles as climate-related financial risks). Physical risks generally refer to the harm to people and property arising from acute, climate-related

[1] In this issuance, the term "financial institution" or "institution" means insured state nonmember banks, state-licensed insured branches of foreign banks that are subject to the provisions of section 39 of the Federal Deposit Insurance Act, and state savings associations.

[2] For additional background, *see* generally Financial Stability Oversight Council, *Report on Climate-Related Financial Risk* (2021). Further, *see* Financial Stability Board, *The Implications of Climate Change for Financial Stability* (2020).

events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification. Transition risks generally refer to stresses to certain financial institutions or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change.

The economic and financial risks associated with physical risks reflect damages to property, infrastructure, and business disruptions, all of which have real effects to the value of property securing financial institutions' exposures and borrowers' ability to perform on their obligations.[3] Regarding transition risks, certain companies or sectors may become less competitive over time as policies implemented to reduce carbon emissions or carbon-equivalents to mitigate the risks of climate change (e.g. carbon pricing), technological advances, and changes in investor and public preferences may all contribute to and accelerate a transition to a low-carbon economy, in each case potentially resulting in reduced profitably and ability to repay obligations for financial institutions' counterparties, as well as reductions in the value for certain assets that are less productive in a low-carbon environment.[4] [5] Transition risks may also increase

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[3] For example, acute physical risks, such as flooding, hurricanes, wildfires, and droughts, may result in sudden, significant, and recurring damage to residential and commercial real estate properties securing exposures held by financial institutions or may otherwise disrupt the operations of their business clients. Further, longer-term gradual physical risks, such as rising average temperatures and sea levels may increase the risk to property values and drive migration patterns as individuals and businesses prioritize geographic areas less exposed to physical risks, which may produce detrimental impacts to household wealth, corporate profitably, local economies and municipalities in certain geographies. *See www.whitehouse.gov*, *Report on the impact of climate change on migration* (2021) *https://www.whitehouse.gov/wp-content/uploads/2021/10/Report-on-the-Impact-of-Climate-Change-on-Migration.pdf.*

[4] Reductions in carbon emissions are often considered through a "carbon equivalent amount", which measures the emissions of various greenhouse gases in terms of their equivalent amount of carbon dioxide with the same global warming potential. For example, *see* Equation A-1 in 40 CFR part 98.

[5] For example, it may become more costly or difficult for certain climate-sensitive investments and businesses to comply with climate policies. Further, delayed implementation of climate policies may result in a more abrupt transition for such climate-sensitive investments and businesses, increasing the risks and ultimate costs of transitioning to a more sustainable economy. Advancements in technology may also accelerate the development of low-carbon energy sources, while investor and public preferences and behavior may result in a shift towards more energy efficient assets and companies earlier than otherwise expected. *See* Network of Central Banks and Supervisors for Greening the Financial System, *NGFS Climate Scenarios for Central Banks and Supervisors* (2020); IEA and IRENA, *Perspectives for the energy transition – Investment needs for a low-carbon energy system* (2017).

litigation, liability, legal and regulatory compliance risks associated with climate-sensitive investments and businesses, or pose other risks to institutions based on shifts in market or consumer preferences. Additionally, the value of financial assets may be adversely affected as market participants reflect the future impacts of both physical and transition risks on financial performance.

From a financial stability perspective, climate-related financial risks have the potential to impact financial institutions and the economy through both macroeconomic and microeconomic factors, such as reductions in economic growth and labor productivity, increased borrowing costs, and higher commodities prices, as well as directly to financial institutions themselves or through their counterparties.[6] These factors contribute to the way in which climate-related financial risks can transmit to a significant number of financial institutions and raise financial stability concerns.

Climate-related financial risks pose a clear and significant risk to the U.S. financial system and, if unmitigated, may pose a near-term threat to safe and sound banking and financial stability. Weaknesses in how institutions identify, measure, monitor, and control the physical and transition risks associated with a changing climate could adversely affect a financial institution's safety and soundness, as well as the overall financial system. Adverse effects could include potentially disproportionate impact on the financially vulnerable, including low- to moderate-income (LMI) and other disadvantaged households and communities.[7] With this, the manner in which financial institutions manage climate-related financial risks to address safety and soundness

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[6] For example, physical and transition risks also have the potential to produce "feedback loops" across the financial system and economy, which can amplify and reinforce the impacts of climate change through procyclical behavior, such as widespread reduction in bank lending and lead to declines in asset valuations and economic growth. Further, interconnections within the financial system can accelerate the spread of a climate-related financial shocks, leading to potential contagion effects if institutions experience shocks as a result of physical or transition risks. *See*, for example, Financial Stability Board, *The Implications of Climate Change for Financial Stability* (2020); Basel Committee on Banking Supervision, *Climate-related risk drivers and their transmission channels* (2021).

[7] For further information, *see* Staff Reports, Federal Reserve Bank of New York, *Understanding the Linkages between Climate Change and Inequality in the United States*, No. 991 (November 2021).

concerns should also seek to reduce or mitigate the impact that management of these risks may have on broader aspects of the economy, including the disproportionate impact of risk on LMI and other disadvantaged communities.

The FDIC recognizes the need for comprehensive risk management guidelines that can be implemented consistently. These draft principles provide a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the risk management framework described in existing FDIC rules and guidance, and are intended to support efforts by financial institutions to focus on the key aspects of climate risk management.[8] The draft principles will help financial institution management make progress toward answering key questions on climate exposures and incorporating climate-related financial risks into financial institutions' risk management frameworks. Additionally, the draft principles are intended to support the use of scenario analysis as an emerging and important approach for identifying, measuring, and managing climate-related risks, as well as risk assessment processes related to credit, liquidity, operational, legal and compliance, and other financial and nonfinancial risks. Some financial institutions, including many large financial institutions, are considering climate-related risks and would benefit from additional guidance as they develop capabilities, deploy resources, and make necessary investments to address climate-related financial risks.

Although all financial institutions, regardless of size, may have material exposures to climate-related financial risks, these draft principles are targeted at the largest financial institutions, those with over $100 billion in total consolidated assets.[9]

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[8] The FDIC has established standards for safety and soundness, as required by section 39 of the Federal Deposit Insurance Act, in part 364 of FDIC Rules and Regulations.

[9] Generally, effective risk management practices should be appropriate to the size of the institution and the nature, scope, and risk of its activities. *See*, e.g., Appendix A to part 364. For purposes of these draft principles, the FDIC generally believes that these standards are particularly salient for the largest financial institutions, those with over $100 billion in total consolidated assets.

The draft principles are an initial step to promote a consistent understanding of the effective management of climate-related financial risks. The FDIC plans to elaborate on these draft principles in subsequent guidance that would distinguish roles and responsibilities of boards of directors (boards) and management, incorporate the feedback received on the draft principles, and consider lessons learned and best practices from the industry and other jurisdictions. In keeping with the FDIC's risk-based approach to supervision, the FDIC intends to appropriately tailor any resulting supervisory expectations to reflect differences in institutions' circumstances such as complexity of operations and business models. Through this and any subsequent climate-related financial risk guidance, the FDIC will continue to encourage institutions to prudently meet the financial services needs of their communities.

II. General Principles

A. Governance

An effective risk governance framework is essential to a financial institution's safe and sound operation. A financial institution's board and management should demonstrate an appropriate understanding of climate-related financial risk exposures and their impact on risk appetite to facilitate oversight. Sound governance includes reviewing information necessary to oversee the financial institution, allocating appropriate resources, assigning climate-related financial risk responsibilities throughout the organization (*i.e.*, committees, reporting lines, and roles), and clearly communicating to staff regarding climate-related impacts to the institution's risk profile. Responsibility and accountability may be integrated within existing organizational structures or by establishing new structures for climate-related financial risks. Where dedicated units are established, the board and management should clearly define these units' responsibilities and interaction with existing governance structures.

The board should have adequate understanding and knowledge to assess the

potential impact of climate-related risks on the financial institution and to address and oversee these risks within the institution's strategy and risk appetite, including an understanding of the potential ways in which these risks could evolve over various time horizons and scenarios. Relevant time horizons may include those that extend beyond the institution's typical strategic planning horizon. The board should actively oversee the financial institution's risk-taking activities and hold management accountable for adhering to the risk governance framework. Management is responsible for executing the financial institution's overall strategic plan. This responsibility includes effectively managing all risks, including climate-related financial risks, and their effects on the institution's financial condition. Management should also hold staff accountable for controlling risks within established lines of authority and responsibility. Additionally, management is responsible for regularly reporting to the board on the level and nature of risks to the institution, including climate-related financial risks.

B. Policies, Procedures, and Limits.

Management should incorporate climate-related risks into policies, procedures, and limits to provide detailed guidance on the institution's approach to these risks in line with the strategy and risk appetite set by the board. Policies, procedures, and limits should be modified when necessary to reflect the distinctive characteristics of climate-related risks and changes to the institution's activities.

C. Strategic Planning

The board and management should consider material climate-related financial risk exposures when setting the institution's overall business strategy, risk appetite, and financial, capital, and operational plans. As part of forward-looking strategic planning, the board and management should address the potential impact of climate-related financial risk exposures on the institution's financial condition, operations (including geographic locations), and business objectives over various time horizons. The board and

management should also consider climate-related financial risk impacts on stakeholders' expectations, the institution's reputation, and LMI and other disadvantaged households and communities, including physical harm or access to bank products and services. The FDIC recognizes that the incorporation of material climate-related financial risks into various planning processes is iterative as measurement methodologies, models, and data for analyzing these risks continue to evolve and mature over time.

Any climate related strategies, including any relevant corporate social responsibility objectives, should align with and support the institution's broader strategy, risk appetite and risk management framework. In addition, where institutions engage in public communication of their climate-related strategies, boards and management should ensure that any public statements about an institution's climate related strategies and commitments are consistent with their internal strategies and risk appetite statements.

D. Risk Management

Climate-related financial risks typically impact financial institutions through a range of traditional risk types. Management should oversee the development and implementation of processes to identify, measure, monitor, and control climate-related financial risk exposures within the institution's existing risk management framework. A financial institution should employ a comprehensive process to identify emerging and material risks stemming from the institution's business activities and associated exposures. The risk identification process should include input from stakeholders across the organization with relevant expertise (*e.g.,* business units, independent risk management, and legal). Risk identification includes assessment of climate-related financial risks across a range of plausible scenarios and under various time horizons.

As part of sound risk management, institutions should develop processes to measure and monitor material climate-related financial risks and to inform management about the materiality of those risks. Material climate-related financial risk exposures

should be clearly defined, aligned with the institution's risk appetite, and supported by appropriate metrics (*e.g.*, risk limits and key risk indicators) and escalation processes. Boards and management should also incorporate climate- related risks into their internal control frameworks, including internal audit.

Tools and approaches for measuring and monitoring exposure to climate-related risks include, among others, exposure analysis, heat maps, climate risk dashboards and scenario analysis. These tools can be leveraged to assess an institution's exposure to both physical and transition risks in both the shorter and longer term. Outputs should inform the risk identification process and the short- and long-term financial risks to an institution's business model from climate change.

E. Data, Risk Measurement, and Reporting

Sound climate risk management depends on the availability of relevant, accurate, and timely data. Management should incorporate climate-related financial risk information into the institution's internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the institution. Effective risk data aggregation and reporting capabilities allow management to capture and report material and emerging climate-related financial risk exposures, segmented or stratified by physical and transition risks, based upon the complexity and types of exposures. Data, risk measurement, modeling methodologies, and reporting continue to evolve at a rapid pace; management should monitor these developments and incorporate them into their climate risk management as warranted.

F. Scenario Analysis

Climate-related scenario analysis is emerging as an important approach for identifying, measuring, and managing climate-related risks. For the purposes of this guidance, climate-related scenario analysis refers to exercises used to conduct a forward-looking assessment of the potential impact on an institution of changes in the economy,

financial system, or the distribution of physical hazards resulting from climate-related risks. These exercises differ from traditional stress testing exercises that typically assess the potential impacts of transitory shocks to near-term economic and financial conditions. An effective climate-related scenario analysis framework provides a comprehensive and forward-looking perspective that institutions can apply alongside existing risk management practices to evaluate the resiliency of an institution's strategy and risk management to the structural changes arising from climate-related risks.

Management should develop and implement climate-related scenario analysis frameworks in a manner commensurate to the institution's size, complexity, business activity, and risk profile. These frameworks should include clearly defined objectives that reflect the institution's overall climate risk management strategies. These objectives could include, for example, exploring the impacts of climate-related risks on the institution's strategy and business model, identifying and measuring vulnerability to relevant climate-related risk factors including physical and transition risks, and estimating climate-related exposures and potential losses across a range of plausible scenarios. In the near term, a climate-related scenario analysis framework can also assist the institution in identifying data and methodological limitations and uncertainty in climate risk management and informing the adequacy of its climate risk management framework.

Climate-related scenario analyses should be subject to oversight, validation, and quality control standards that would be commensurate to their risk. Climate-related scenario analysis results should be clearly and regularly communicated to all relevant individuals within the institution, including an appropriate level of information necessary to effectively convey the assumptions, limitations, and uncertainty of results.

III. Management of Risk Areas

A risk assessment process is part of a sound risk governance framework, and it

allows boards and management to identify emerging risks and to develop and implement appropriate strategies to mitigate those risks. Boards and management should consider and incorporate climate-related financial risks when identifying and mitigating all types of risk. These risk assessment principles describe how climate-related financial risks can be addressed in various risk categories. The FDIC will elaborate on these risk assessment principles in subsequent guidance.

A. Credit Risk

The board and management should consider climate-related financial risks as part of the underwriting and ongoing monitoring of portfolios. Effective credit risk management practices could include monitoring climate-related credit risks through sectoral, geographic, and single-name concentration analyses, including credit risk concentrations stemming from physical and transition risks. As part of concentration risk analysis, management should assess potential changes in correlations across exposures or asset classes. The board and management should determine credit risk appetite and lending limits related to these risks.

B. Liquidity Risk

The board and management should assess whether climate-related financial risks could affect liquidity and, if so, incorporate those risks into their liquidity risk management practices and liquidity buffers.

C. Other Financial Risk

Management should monitor interest rate risk and other model inputs for greater volatility or less predictability due to climate-related financial risks. Where appropriate, management should include corresponding measures of conservatism in their risk measurements and controls. The board and management should monitor how climate-related financial risks affect their institution’s exposure to risk related to changing prices. While market participants are still researching how to measure climate price risk, the

board and management should use the best measurement methodologies reasonably available to them and refine them over time.

D. Operational Risk

The board and management should consider how climate-related financial risk exposures may adversely impact an institution's operations, control environment, and operational resilience. Sound operational risk management includes incorporating an assessment across all business lines and operations, including third-party operations, and considering climate-related impacts on business continuity and the evolving legal and regulatory landscape.

E. Legal/Compliance Risk

The board and management should consider how climate-related financial risks and risk mitigation measures affect the legal and regulatory landscape in which the institution operates. This consideration includes possible changes to legal requirements for, or underwriting considerations related to, flood or disaster related insurance. It also includes possible fair lending concerns if the financial institution's risk mitigation measures disproportionately affect communities or households on a prohibited basis such as race or ethnicity.

F. Other Nonfinancial Risk

Consistent with sound oversight, the board and management should monitor how the execution of strategic decisions and the operating environment affect the financial institution's financial condition and operational resilience as discussed in the strategic planning section. The board and management should also consider the extent to which the financial institution's activities may increase the risk of negative financial impact from reputational damage, liability, or litigation, and implement adequate measures to account for these risks where material.

IV. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3521) (PRA) states that no agency may conduct or sponsor, nor is the respondent required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

These draft principles do not revise any existing, or create any new, information collections pursuant to the PRA. Therefore, the FDIC is not making a submission to OMB.

V. Request for Comment

The FDIC welcomes feedback on all aspects of these draft principles, including on the following questions. Among other uses, the FDIC would consider responses in connection with developing any future guidance on climate-related financial risks.

A. Applicability

Question 1: What additional factors, for example asset size, location, and business model, should inform financial institutions' adoption of these principles?

B. Tailoring

Question 2: How could future guidance assist a financial institution in developing its climate-related financial risk management practices commensurate to its size, complexity, risk profile, and scope of operations?

C. General

Question 3: What challenges do financial institutions face in incorporating these draft principles into their risk management systems? How should the FDIC further engage with financial institutions to understand those challenges?

Question 4: Would regulations or guidelines prescribing particular risk management practices be helpful to financial institutions as they adjust to doing business in a changing climate?

D. Current Risk Management Practices

Question 5: What specific tools or strategies have financial institutions used to successfully incorporate climate-related financial risks into their risk management frameworks?

Question 6: How do financial institutions determine when climate-related financial risks are material and warrant greater than routine attention by the board and management?

Question 7: What time horizon do financial institutions consider relevant when identifying and assessing the materiality of climate-related financial risks?

Question 8: What, if any, specific products, practices, and strategies – for example, insurance or derivatives contracts or other capital market instruments – do financial institutions use to hedge, transfer, or mitigate climate-related financial risks?

Question 9: What, if any, climate-related financial products or services – for example, "green bonds," derivatives, dedicated investment funds, or other instruments that take climate-related considerations into account – do financial institutions offer to clients and customers?[10] What risks, if any, do these products or services pose?

Question 10: How do financial institutions currently consider the impacts of climate-related financial risk mitigation strategies and financial products on households and communities, specifically LMI and other disadvantaged communities? Should the agencies modify existing regulations and guidance, such as those associated with the Community Reinvestment Act, to address the impact climate-related financial risks may have on LMI and other disadvantaged communities?

E. Data, Disclosures, and Reporting

Question 11: What, if any, specific climate-related data, metrics, tools and models from borrowers and other counterparties do financial institutions need to identify, measure, monitor, and control their own climate-related financial risks? How do financial

[10] "Green bonds" generally refer to fixed-income securities, the proceeds of which are earmarked for environmentally beneficial investment.

institutions currently obtain this information? What gaps and other concerns are there with respect to these data, metrics, tools or models?

Question 12: How could existing regulatory reporting requirements be augmented to better capture financial institutions' exposure to climate-related financial risks?

F. Scenario Analysis

Question 13: Scenario analysis is an important component of climate risk management that requires assumptions about plausible future states of the world. How do financial institutions use climate scenario models, analysis, or tools and what challenges do they face?

Question 14: What factors are most salient for the FDIC to consider when designing and executing scenario analysis exercises?

Federal Deposit Insurance Corporation.

By order of the Board of Directors.

Dated at Washington, DC, on March 29, 2022.

James P. Sheesley,

Assistant Executive Secretary.

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